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Navigating Liquidity Pressures in Tanzania's Banking Sector

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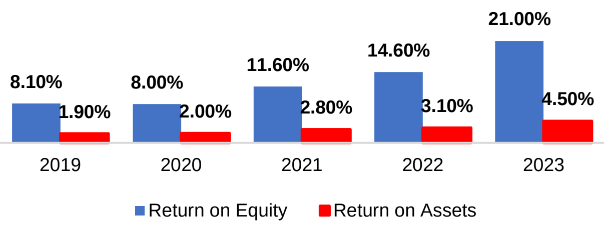
Introduction

According to the Tanzanian Financial Stability Report for 2023, the banking sector has had a prosperous five years with a gradual and steady improvement in profitability, supported by a surge in net interest income growth, better cost management, and diversification into non-interest income streams such as foreign exchange activities, fees from loans, and digital banking services such as those from Internet and mobile banking as well as agency banking. The sector's balance sheet has also remained robust, with assets recording a compound annual growth rate (CAGR) of 13.28% between 2019 and 2023. This growth has primarily been fuelled by increased investments in income-generating assets such as government securities, particularly loans, and advances to customers whose surging growth has been supplemented by increased credit appetite from the private sector and rising disposable income amongst the middle class.

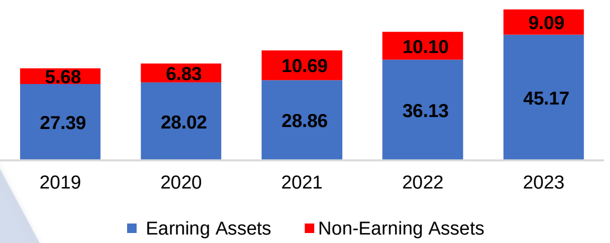
Despite such positive prospects, the banking sector's main source of financing, which is customer deposits, has not been growing at equivalent proportions to those of the sector's investments into its earning assets, as both individuals and corporations get exposed to more opportunities that provide them with the prospects of greater returns than placing their funds as deposits. This creates a liquidity challenge in the banking sector as they are increasingly placed in a business environment where the rate at which they invest is greater than the rate at which they acquire the necessary financing to make the investments. The following sections of this article highlight several indicators that show that the sector is facing a liquidity challenge, the ramifications of the liquidity challenge in the banking sector, and potential solutions that can help alleviate the banking sector from this particular challenge.

Tanzanian Banking Sector Profitability Ratios Trend



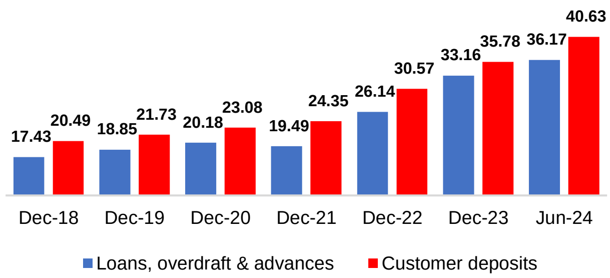
Source: Bank of Tanzania

Banking Sector Total Assets in Trillions TZS



Source: Bank of Tanzania

Banking Sector Gross Loans & Customer Deposit Trend in Trillions TZS



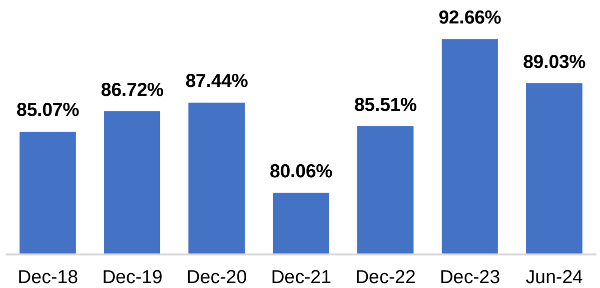
Source: Bank of Tanzania

Factors that Indicate the Banking Sectors' Liquidity Challenges

1. Higher disbursements of loans compared to Deposit Mobilization

According to the Financial Stability report for 2023, the banking sector gross loans to customers deposit ratio, which is an indicator of how much in customer loans have been disbursed for every TZS 1 of a customer's deposit, indicates a growing trajectory from 88.50% as of 2019 to 92.70% as of 2023. This growth largely stems from loans and advances to customers growing faster than customer deposits, with the rapid growth in loans particularly stemming from increased demand for credit from the private sector, as highlighted in the introduction section.

Banking Sector Gross Loans to Deposit Ratio Trend



Source: Bank of Tanzania

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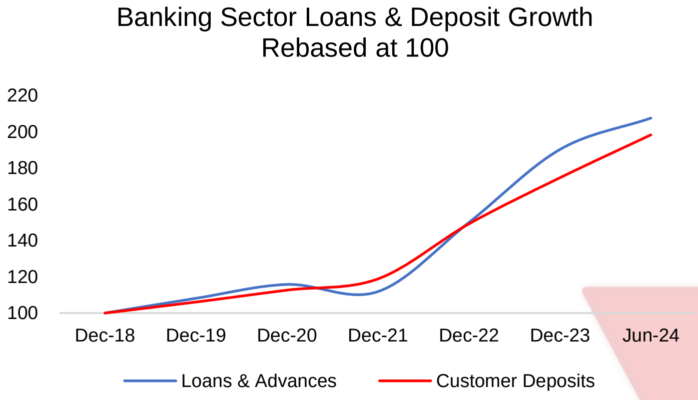
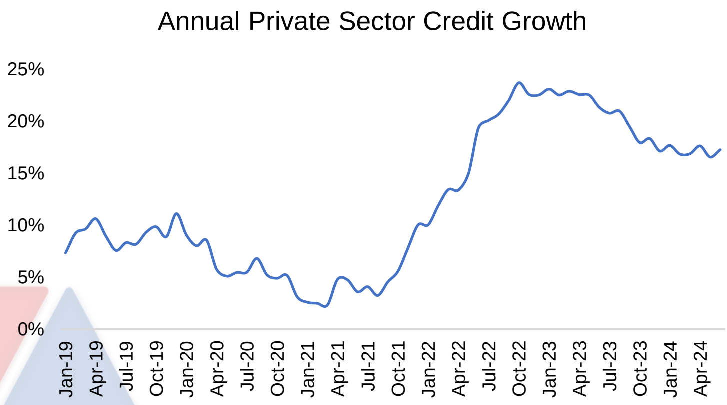
Factors that Indicate the Banking Sectors' Liquidity Challenges

For the six months ending June 2024, we have begun to see a shift in the growth curve for loans and deposits as gross loans grow at a decelerated rate of 9.10%, amounting to TZS 36.17 trillion, while deposits grow at 13.55%, amounting to TZS 40.63 trillion. The shifting dynamics observed during the first six months of 2024 could be caused by banks' opting to tighten the disbursement of loans by repricing interest rates upwards to reduce credit appetite from their customers, all while conserving liquidity.





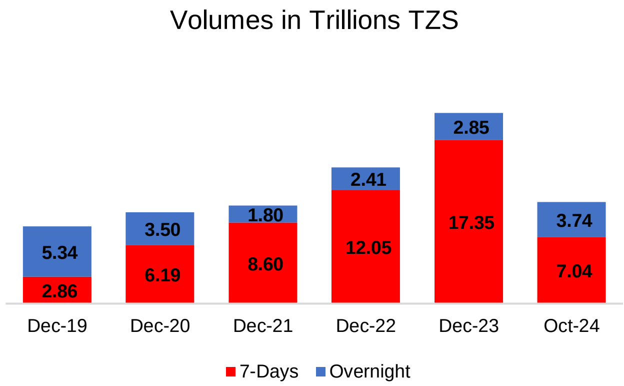
Source: Solomon Stockbrokers Research Department, Bank of Tanzania

2. Increased borrowings

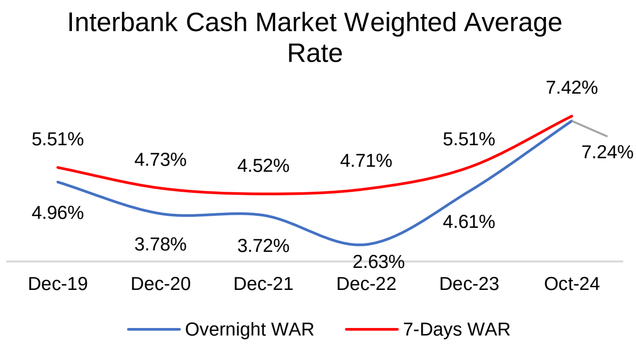
In an effort to remain compliant and meet customer demand for loans in an environment where deposit mobilization is not enough, banks opt to raise funds in the form of short—and long-term borrowings to meet both their liquidity requirements and customer appetite for credit. Commercial banks can use a variety of avenues to raise the necessary funds. Common avenues to which this is done are further explained below:

a. Interbank Cash Markets (IBCM)

The Interbank Cash Market is a money market in which banks lend and borrow funds. The money raised from this market tends to be more short-term and is usually lent to meet Central Bank liquidity needs between 2019 and 2023; overnight and 7-day borrowings in the Interbank Cash Market grew at a C.A.G.R of 25.29% from TZS 8.20 trillion in 2019 to TZS 20.20 trillion in 2023, indicating an increased reliance on inter-bank borrowings to meet liquidity needs. However, it's worth highlighting that as of the period between Jan 2024 – Oct 11th 2024, borrowings from the overnight and 7-day IBCM have seen a 46.64% decline from TZS 20.20 trillion in 2023 to TZS 10.78 trillion in 2024, perhaps due to the lack of willingness to borrow money from this segment due to the escalated rates as a result of the introduction and subsequent hiking of the Central Bank Policy from 5.5% to 6% and the lack of available funds amongst banks to facilitate interbank lending in a shortage of funds in the market, thus causing interest rates to remain heightened.

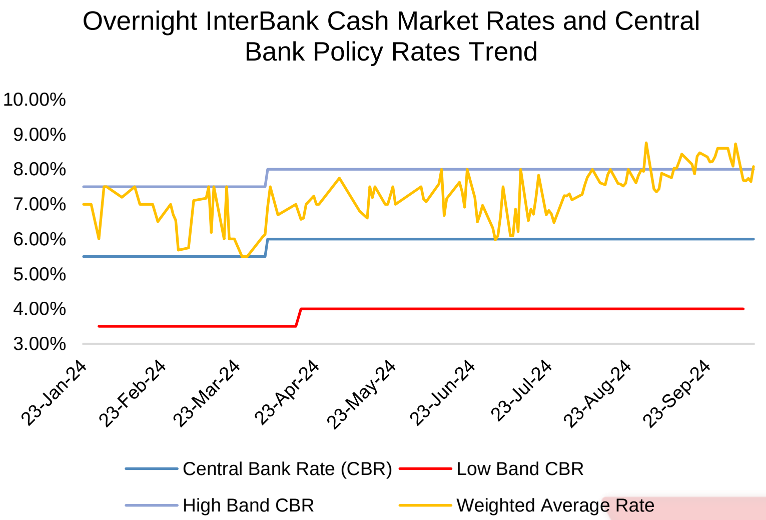


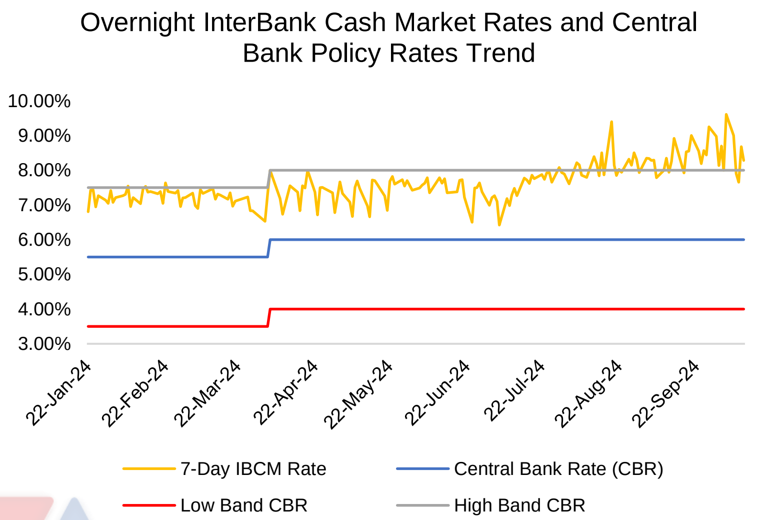
Source: Bank of Tanzania



Source: Solomon Stockbrokers Research Department, Bank of Tanzania

Factors that Indicate the Banking Sectors' Liquidity Challenges

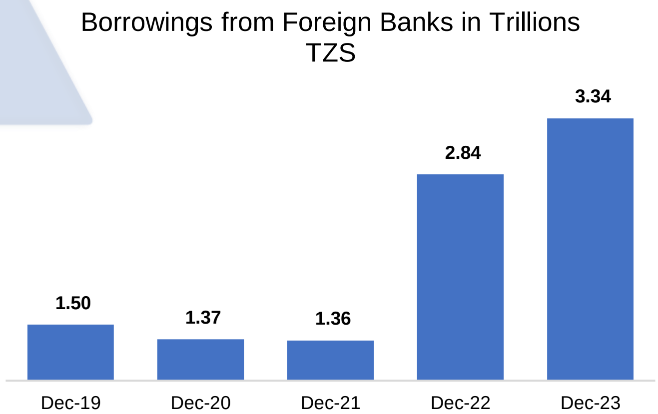




Source: Bank of Tanzania

b. Foreign Borrowings

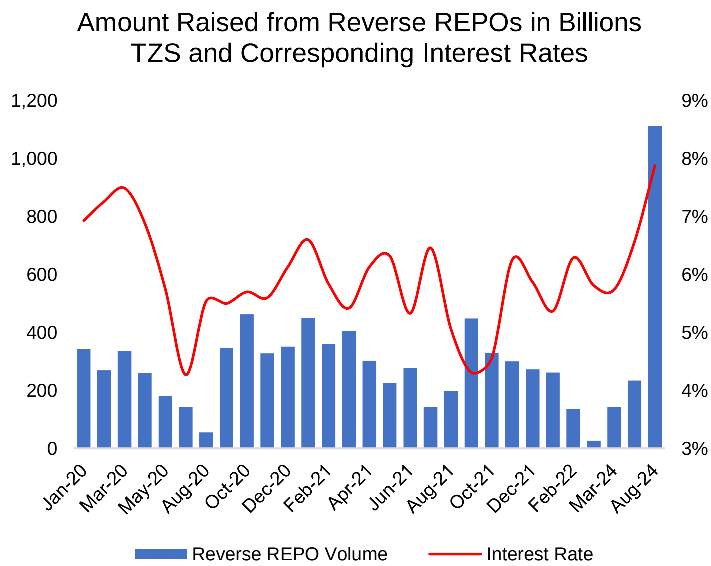
Banks have opted to take on foreign-denominated borrowings, with most of the money raised intended to finance long-term projects. Thus, they tend to be long-term funds. During the 5-year period between 2019 and 2023, these borrowings have grown at a 22.16% compound annual growth rate (C.A.G.R) from TZS 1.50 trillion in 2019 to TZS 3.34 trillion in 2023.



Source: Bank of Tanzania

c. Reverse Repurchase Agreements

A reverse Repurchase Agreement (REPO) is a monetary policy tool that allows the Central Bank to provide short-term lending to commercial banks by buying a portion of their government securities investments, and in exchange, the commercial banks agree to repurchase those bonds from the Central Bank at a higher rate. When the banking sector taps into reverse REPOs for borrowings, that indicates that they do not have the necessary liquidity to finance loan disbursements all while meeting demand deposits; thus, to continue facilitating growth and or comply with liquidity regulations, the sector opts to use these borrowings as a way to finance its operational activities. In 2024, the Central Bank issued TZS 1.52 trillion worth of reverse REPOs to Commercial Banks, the first time it reissued REPOs since 2022.



Source: Bank of Tanzania

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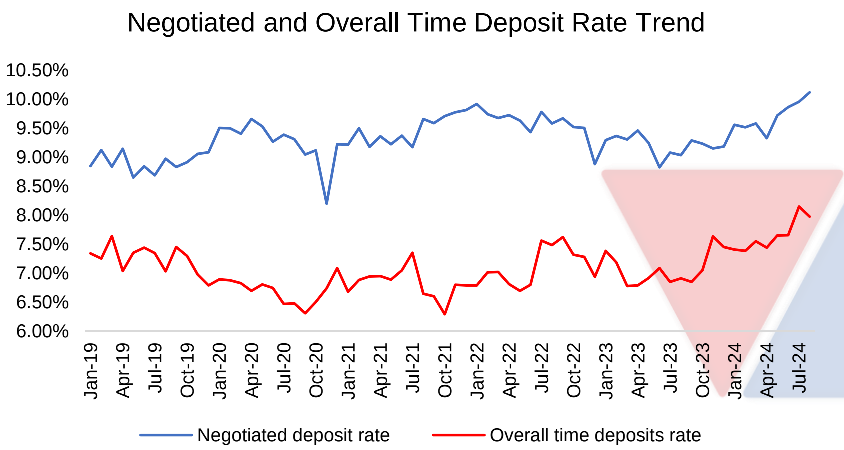
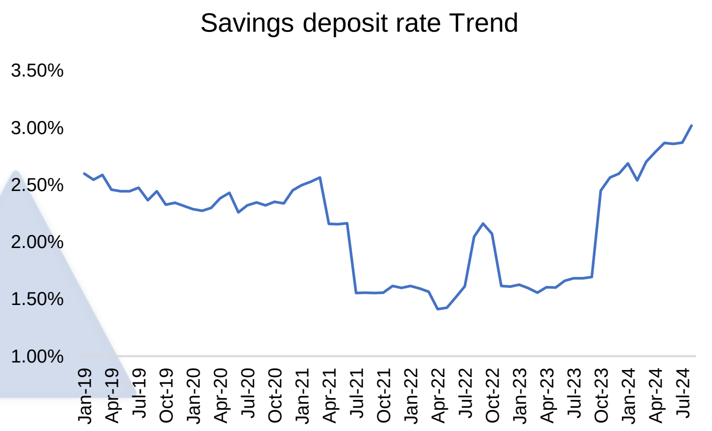
Ramifications of the Liquidity Challenge to the Banking Sector

1. An escalation in the cost of funds

As banks scramble for deposits, issuing higher interest rates is the best way to ensure a bank attracts more deposits than its competitors. This is evident with the growth in interest rates on time and savings deposits in the charts illustrated below. Furthermore, the shortage of funds amongst banks to lend in the Interbank Cash Market, in addition to higher Central Bank rates, has brought about an increase in funding costs from the money markets, as previously highlighted, which will continue to increase the banking sector interest expenses and put pressure on the bank's net interest income and profits.

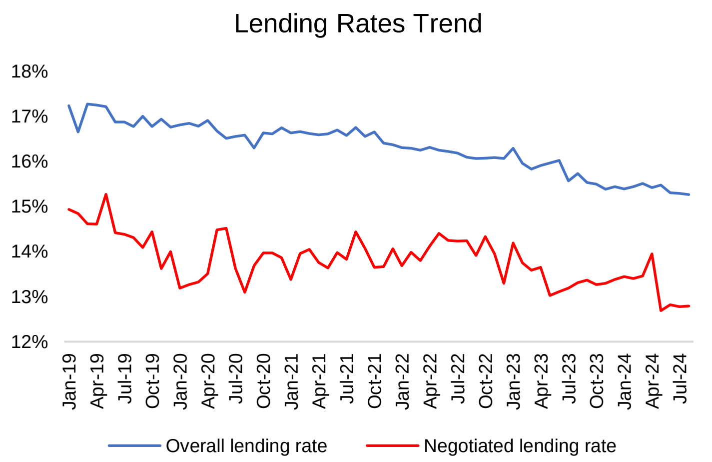




Source: Bank of Tanzania

2. Higher interest rates on loans

As the cost of funds continues to escalate, the banking sector could be prompted to reprice future loan disbursements upwards, which could deter future demand for credit amongst households and the private sector. While the data from the Bank of Tanzania for the period ending August 2024 has not reflected any major increments in lending rates, since lending rates on already disbursed loans tend to be fixed rather than variable, it is worth highlighting that some major banks have begun repricing interest rates on newly issued loans upwards which could result higher overall and termed lending rates reported by the Central Bank in forthcoming months.



Source: Bank of Tanzania

3. Pressure on Small and Medium-Sized Banks

Small and Medium-Sized banks are likely to feel the full brunt of the liquidity crisis since, due to their higher risk status quo and lack of presence compared to larger banks, they are likely to charge above-average rates on their deposits to attract more clients. Additionally, interest rate expenses on their short and long-term borrowings are likely higher due to their higher perceived risk. This degrades these bank's profitability at a much higher rate than larger banks, setting the theme for further consolidation. Such banks would likely have to pursue a merger or acquisition to remain strengthened.

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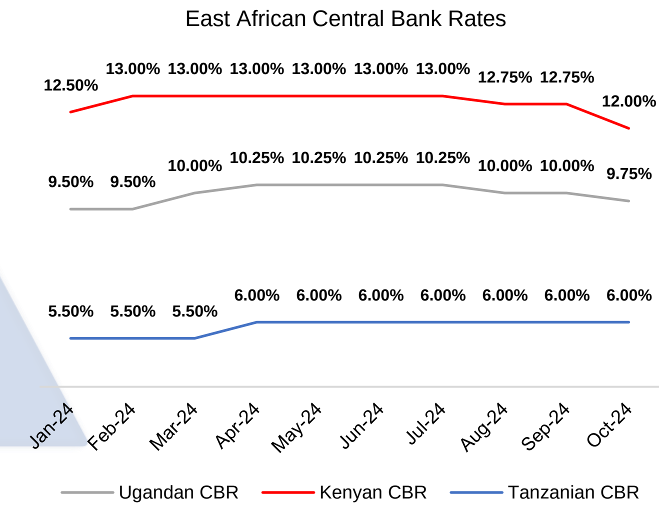
Potential Solutions to the Banking Sectors' Liquidity Challenge

In light of the existing liquidity challenge facing the banking sector and the potential ramifications that have started to play out and that may continue to play out as a result of this challenge to the banking institutions and their stakeholders, several proactive approaches may be taken by the Banks and regulator to help alleviate the sector from the liquidity challenge all while promoting sustainable growth within the banking sector. These initiatives are further analyzed below:

1. Initiatives that could be taken by the Bank of Tanzania

a. Lowering Central Bank Rates (CBR)

According to the Monetary Policy Committee Statement issued on 3rd October 2024, Central Bank Rates were maintained at 6% for the quarter ending December 2024. This is despite global and economic growth being projected to improve, inflation remaining stable and below national and regional targets, a deceleration in money supply growth, the banking sector's non-performing loan ratio, and an improvement in foreign exchange inflows. If prospects remain within targets and continue to improve, then reducing Central Bank rates should relieve pressure on the banking sector's internal sources of borrowing, such as via the IBCM and the reverse REPOs, allowing for greater liquidity and cheaper cost of funds.

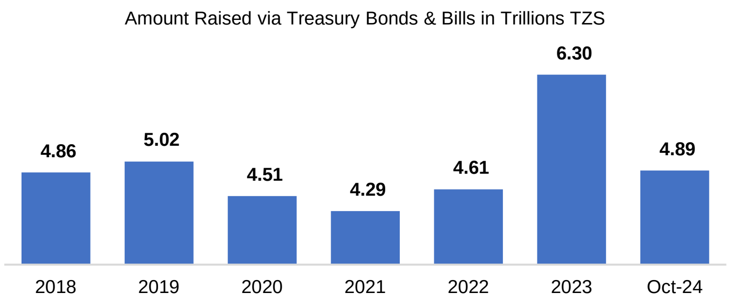


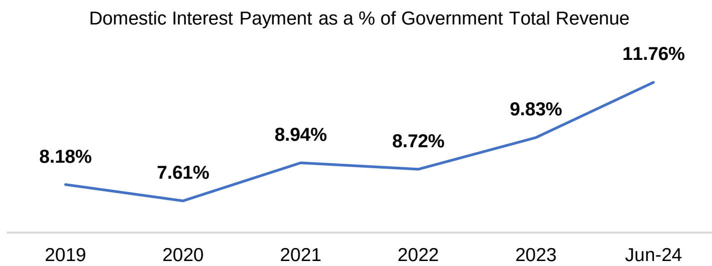
Source: Bank of Tanzania, Central Bank of Kenya & Bank of Uganda

However, it is worth highlighting that even if Tanzania maintains and meets its macroeconomic and sector-specific thresholds well into 2025, the CBR might not be revised downwards since, in addition to meeting required macroeconomic and sector-specific thresholds, the Central Bank is likely looking for convergence between Tanzania's policy rates and those of regional East African countries to avoid capital flight amongst Tanzanian investors into neighboring countries to seek higher returns on their cash.

b. Reducing Liquidity Mop-ups via Open Market Operations

The Central Bank could alternatively limit the use of domestic debt securities (treasury bills and bonds) to raise money to finance government expenditure; this would help increase the amount of money circulating the economy and thus create room for more depository inflows for the banking sector. The Central Bank could achieve this by limiting the issuance of investors' preferred long-term treasury bonds, such as 20- and 25-year government bonds. Reducing debt financing could also coincide with the Central Bank's plan to ensure sustainable economic transformation via Fiscal Consolidation, as highlighted in the 2024/25 Budget Speech since it would result in less TZS being spent to finance interest payments.





Source: Bank of Tanzania

Potential Solutions to the Banking Sectors' Liquidity Challenge

2. Initiatives that could be taken by the Banking Sector

a. Opting for sustainable growth

Commercial banks can enhance liquidity by better matching the maturity of their loans and deposits through their Asset-Liability Committee (ALCO) while focusing on increasing deposits and creating a value chain that promotes deposit retention. One effective way to retain deposits is by making digital transactions more convenient for customers, thus reducing their reliance on cash-based transactions. In addition to deposit mobilization & retention strategies, banks should diversify their revenue streams by reducing dependency on interest income; this could be achieved by transitioning from the traditional commercial banking model towards becoming a one-stop shop to provide all financial services. By doing this, the contribution of the bank's non-interest income would increase to greater proportions, allowing for more sustainable growth and the delivery of stronger shareholder returns.

b. Diversifying funding sources

In addition to relying on deposits and borrowings from foreign banks and money markets, banks can think and innovate newer ways of attracting the funds needed to improve liquidity and/or acquire funds to bolster growth. Some approaches could be leveraging more on issuing long-term corporate bonds via Tanzanian Debt markets, securitizing assets, and/or raising equity via selling different shares of different classes.

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